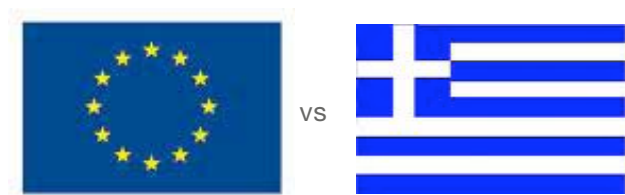




# MONTHLY REPORT

MAY 2010

## THE GREEK DEBATE



Fear and contagion have broken out in European sovereign bond markets. The well documented government debt problems in Greece - prompted the Greek government to ask for emergency funding from the IMF.

Bond investors pushed up yields in Portugal, Spain and Ireland, concerned by the possibility that these economies might be next in the IMF queue. Standard & Poor's reacted by downgrading Greece by three notches to BB+ or junk status, while reducing Portugal's sovereign rating from A+ to A- and Spain's by one notch to AA. If Greece is in such a bad way, should we be worried about other Euro-zone economies with, what are on the face of it, a similar set of fiscal pressures?

On balance, probably not; Greece is a basket case. It is the 'weakest link' in the Euro-zone by a significant margin. And, while other economies have their problems, there are reasons to believe they are surmountable. We do believe this is a glitch on what will be viewed as a short term correction in a Bull Market.

The following points further explain the Greece situation and what affect it may have on the world economy.

### LOOKING AHEAD IN THE SHORT TERM

- We expect the EU package to be made available before the next date at which Greece requires to roll-over upcoming maturities, 19<sup>th</sup> May.

- The size of the package will increase (with the support of the IMF) to maybe as high as EUR100bn -120bn to extend beyond the 1 year horizon that the current EUR45bn could cover.
- In an extended period where Greece does not require private market access, the necessary fiscal consolidation can continue in earnest.
- It is also possible that the ECB further loosens its collateral eligibility rules so that Greek Government bonds remain eligible for repo, although this is more a method for preserving the integrity of the banking system than assisting the Greek Government.

### LOOKING AHEAD IN THE MEDIUM TERM

- The basic problem that needs solving in Greece (and to a lesser extent in Portugal, Spain and Italy also) is that of competitiveness.
- Since the birth of the Eurozone, there has been a gradual rebalancing of relative price levels between the North and South Eurozone and the generation of large intra-regional trade deficits in the South. This, in conjunction with poor fiscal discipline has led the South into a position of having an unsustainable Government financing position.
- To rebalance, and thus gain competitiveness (in the absence of a currency devaluation solution – which, of course, is removed by the inherent fixed exchange rates of a currency union) requires either inflation in the North or deflation in the South to take place through an adjustment period that may take many years.
- The Euro regime, in its current form, (and indeed the obvious preferences of the Northern Eurozone population) precludes the "Inflation in the North" route. "Deflation in the South" i.e. the burden of adjustment falling wholly upon the deficit countries, becomes the only route – the implication is that

the standard of living in the South has to fall during the adjustment process; whether the public can support such a prospect is still very unclear.

We think the EU/IMF will put in place a package that stabilises the deterioration. This will buy time for Greece to commence its retrenchment and address the most obvious causes of contagion in the Southern Eurozone, but does not rule out further issues, in Spain for example, that would be much more problematical to solve.

Whether Greece remains in the Eurozone or not, we believe Greek Government obligation will need to be restructured. However, we see little likelihood that this is a 2010 issue.

## DEVELOPED EQUITY/ECONOMIES

- The rally in global equities has intensified in recent weeks as a resolution to Greece has supported and economic fundamentals continue to improve.
- While isolated periods of consolidation are highly likely after such a robust rebound (MSCI World Index +51.5% on one-year trailing basis in USD)\* we maintain our upward bias for equities through year-end.
- In addition to potential near-term catalysts such as tempering of sovereign debt fears the increasingly possibility of job growth in the U.S. and reporting season for Q1, fundamentals remain constructive.
- We do not feel that the rebound in economic and earnings growth (most global equity regions expect earnings growth in excess of 20% in 2010) is fully reflected in equity prices, especially when compared to richer valuations in the fixed income market.
- In addition, positive fund flows from retail and institutional investors, hedge funds and corporations (via M&A) are in the early stages while confidence at both the CEO and consumer level is improving.

- Return prospects and valuations remain attractive across developed markets.
- The U.S. has better growth prospects and a higher earnings growth estimate
- Within Euroland: Favor Germany. Although the broad European economy may be under pressure, Germany should benefit from a flight to quality, the weak euro should benefit corporate profits and a rebound in economic activity should boost exports.
- U.S. favored sectors: Selected cyclicals (e.g. energy) as well as tech given their cash-rich balance sheets and expectation for the business recovery to be driven by increased cap ex spending. In addition, staples and healthcare are attractive as a result of compelling valuations. We remain cautious on consumer discretionary due to deleveraging and utilities due to the forecasted rising rate environment.

## EMERGING MARKETS

- **Performance:** Emerging stock markets caught up (after underperforming at the start of the year) since February as global risk aversion calmed down and it became clearer that growth dynamic in the large Emerging Markets is so strong that monetary tightening is a timely move to prevent overheating and not likely to dampen growth seriously.
- **Monetary tightening** has started in large emerging markets. China has already brought down the rise in bank lending via reserve requirements. An official rate hike is not imminent, but likely by summer.
- **Regional recommendations:** After **Eastern Europe** outperformed recently on the back of its lag in the global cycle and on robust energy prices (Russia with 50-70% weight in all EM Europe indices), although we like this region as a long term view, we do not recommend an overweight position in the short term as it is prone to contagion of any heightened debt crisis volatility.

- **Brazil:** Upside on the back of very strong GDP growth revised up to a path visibly above potential growth. But upside is limited by valuation and increasing headwinds (substantial tightening expected this year.. Strong GDP growth above potential and the upcoming rate cycle lead us to prefer commodity stocks to domestic stocks which usually under-perform during initial rate hikes.
- **China:** Economic growth possibly surprising to the upside and more balanced growth (domestic demand robust, fixed asset investment rising less). The strong growth dynamic will be reflected in profitability, as well as the steep rise in productivity. Worries about tightening and inflation exaggerated. Trigger for stock markets could be moderate inflation rates. Rising supply from domestic banks' capital raising is likely to be choked up by domestic institutional investors. **Outlook for currency appreciation attracts foreign capital.**
- **India:** Stock market likely to benefit from strong growth. Tightening measures were necessary to limit inflation expectations, but near term less interest-rate sensitive sectors preferred:

## ABSOLUTE RETURN

- **Reshuffling the cards for 2010**  
Hedge funds came in slightly positive in Feb and added another percent by mid-March. The industry is thus now in a position to tackle the remainder of the year 2010 from a point of positive performance. Equities snapped back further in March with US and UK stocks now firmly positive and Emerging Markets and Euro zone stocks slightly up year-to-date.
- The S&P 500 lost -50.9% from the end of Oct. 2007 through the end of Feb. 2009. The index gained roughly the same amount in the subsequent recovery period (+53.6% thru Feb. 2010). As a result, US stocks were still down about one quarter

(-24.6%) by the end of Feb. 2010. Contrasting with this, the average single hedge fund lost a more moderate -21.4% during the stock market drawdown. Also, the recovery was much less effervescent (+21.5%). The industry has not yet fully recovered, but the full period performance only shows a modest loss of -4.6%, which compares well with the stock market

- **Property demand has risen.** Global commercial real estate transaction volumes likely bottomed in 1Q09. Property demand in Asia and Europe has risen most visibly while activity in the U.S. commercial real estate (CRE) market remains relatively subdued.
- The **main risks** to a further improvement in property markets are a material setback in economic growth, broad-based refinancing problems and a significant rise in interest rates due to technical reasons (e.g. increased supply of government bonds, termination of quantitative easing programs) rather than improved economic prospects or higher inflation rates.

## COMMODITIES

- Despite uncertainty surrounding the rising fiscal debt burdens in the developed economies and fiscal and monetary tightening in the emerging markets, we believe the global economic recovery will continue to drive commodity prices higher.
- We maintain our expectation that the emerging markets will lead the expansion and incremental commodity demand. China is likely to lead developing market growth despite the two bank reserve requirement increases as new loans continue to grow. The U.S. remains on steady ground as unemployment appears to have peaked, manufacturing activity is expanding and consumer sentiment is improving. However, the pace of expansion is likely to slow as the rise in the leading indicators has slowed and the Federal Reserve is expected to start raising interest rates in 2010

Over the past week we have seen both hard and soft commodities tumble on the back of a strengthening USD and credit concerns in Greece. We do not anticipate this trend to continue over the medium to longer term.

## GOLD

- Gold remains an attractive hedging tool given the fiscal uncertainty in Europe (e.g. Greece) and gold's "safe haven" status. However, given the historical tendency for cyclical commodities to outperform the "safe havens" in periods surrounding monetary tightening and against the background of a stronger USD, we anticipate gold will lag.
- Industrial metals continue to benefit from the rebound in industrial activity and increased real economic activity in the resource intensive emerging economies. However, due to stubbornly high inventories and given the magnitude of the rally in metals prices, selectivity in the industrial metals complex is critical.
- As the southern hemisphere begins its harvest season and the northern hemisphere begins planting its spring crop, grains prices will be driven by weather and planting intentions in the north. Selectivity is important as corn stocks-to-use remain below their historical average while wheat is in-line and soybeans are historically elevated.

## FOREX

- EUR weakness persisted despite robust macro economic data and a further rise of business climate indicators. The main reasons were continuing concerns about the state of public finances in some EMU member countries and associated worries about the currency union as a whole.
- Growth-sensitive currencies still seem well-supported in the current environment where low rates in industrialised countries and increased

household savings keep the hunt for higher yields going. We particularly like CAD, NOK and NZD, less so AUD. Looking further down the road these currencies could yet be impaired by a change of US interest rate expectations, especially if changed Fed rhetoric caused the front end to rise.

- Recent rhetoric of Chinese officials has fuelled expectations that a less rigid exchange rate policy may lie ahead. Put differently, markets expect that Chinese authorities may be willing to let the yuan appreciate sooner rather than later. We expect this to be a gradual long-term process and not a one-off revaluation.

## CONCLUSION

Global economic growth remains robust. Corporate earnings are healthy. The recovery in stock and credit markets is unlikely to be materially derailed by the recent events in Greece, which should ultimately be contained. Greece was always going to need a bail-out, given the severity of the problems. That is not to say that other countries in the Euro-zone such as Spain, Portugal and the UK do not have tough choices to make however, unlike Greece, they have more scope with which to make them.

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